4. The Company argues that Wash. Const. Art. XII, Sec. 19 declares that telephone companies are common carriers and subject to regulation. It contends that the proposal regulates advertising, and notes that advertising is not included as a business subject to regulation under the Constitution.

The Commission rejects this argument. The Commission exercises no jurisdiction over advertising, which is not regulated in any way by this proposal. Only the utility is regulated or affected, pursuant to statutory and Constitutional authority .

5. The Company argues that RCW 80.04.270 forbids the Commission from considering revenues from the sale of merchandise as part of a regulated company's operating revenues. Although US WEST argues that merchandise is not defined in the statute, it argues that printed advertisements are clearly merchandise and within the terms of the statute.

The Commission rejects this argument. Merchandise includes all goods which merchants usually buy and sell.[22] US WEST Direct is not a printing job shop, and the advertiser is not purchasing any goods of any kind. The Commission finds that the advertiser is purchasing the service of having advertisements printed and distributed to every telephone subscriber. The advertiser has no property right in any printing, printed advertisements, or other physical property as a result of the advertisement. Thus there is no sale of merchandise, and the statute is inapplicable.

6. The Company argues that the Commission's general power to regulate in the public interest or to approve affiliate contracts does not authorize imputation.

The Commission rejects this argument. The issue here is not contract approval; it is accounting for income and expenses and assigning responsibility for the reasonable operation of the utility and the Company's dealing with a regulatory asset. The Commission clearly has authority to do that under its power to regulate in the public interest.

7. USWC argues that the company has not acquiesced or waived its rights. There was no rate case, prosecuted to conclusion, in which imputation was an issue. The order in U-86-156 was appealed but dismissed upon the agreement of both parties that the orders were not final. No settlement temporarily acquiescing in imputation can be used as a waiver.

Whether or not the Company waived its rights, it has accepted imputation as an element of the AFOR. The dismissal of the order in U-86-156 does not diminish the force of the Commission's logic and the correctness of its analysis.

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[22] Black's Law Dictionary, 5th Ed. (1979), at 890.

8. USWC argues that under the Telecom Act, universal service may only be subsidized on an equitable and nondiscriminatory basis, and imputing income to USWC is improper because there is no evidence subsidies are needed by all customers including those who may be millionaires.

The Commission rejects this argument. The proposal is not a universal service subsidy. It is a ratemaking adjustment. Its purpose is to reflect funds that would be available to the Company, but for Company action. In any event, the Commission finds in this Order that existing rates for local exchange service do cover incremental costs of providing that service, which thus needs no "subsidy", and the Commission does not attribute or "earmark" the directory imputation directly to any class of customers. Therefore the subsidy argument is inapposite.

9. USWC argues that the Commission cannot explore whether USWC acted reasonably in transferring the directory because management decisions belong to the Company, not the regulator. It cites Missouri v. Southwestern Bell, 262 US 276 (1923) for the proposition that regulated companies retain their management prerogatives.

The Commission rejects this argument. It is not interfering with management prerogatives in any way. The Commission did not prevent company management from doing anything. The Commission is making a ratemaking adjustment for excessive earnings that the Company earned or could have earned or retained the right to earn, based on agreement and historical precedent.

10. The Company argues that nothing in U-86-156 or U-89-3524-AT decide this issue.

i) The Company contends that the orders do not address today's policy issues: cross subsidization and harm to competition. The Commission rejects the argument. The earlier orders did not anticipate and do not address some current circumstances or policy issues. That does not render them invalid. The Commission has the power to modify earlier orders when it believes doing so is appropriate, under pertinent statutes.

ii) The Company argues that neither docket was a rate case and no finding in those cases forecloses USWC from litigating the issue of subsidizing competitive and potentially competitive telecommunications services with Directory income; the agreement is obsolete. The Commission rejects the argument. That neither prior proceeding was a rate case appears to be irrelevant. The Commission specificallly finds that the imputed revenues do not provide a subsidy to any customers or class of customers. The agreement is not shown to be obsolete.

iii) The Third Supplemental Order in U-89-3524 did not actually affect rates and thus was not ripe for appeal on this issue. The Commission rejects the argument. The Commission disagrees that the order was not ripe for appeal; whether the order actually affected rates would not determine whether it was appealable.[23]

iv) MRG gets listings on the same basis as other companies. The Commission rejects the argument. MRG's access to listings and preferential or lack of preferential status regarding access to the listings are not the basis for this decision. The Commission is not regulating MRG but is attributing revenues based on several grounds: the Company's foregoing its ability to maintain a historically integrated operation benefiting ratepayers, its failure to secure benefit for losing the regulatory asset, and its failure to secure compensation for the benefits that MRG currently enjoys. MRG's current market advantage stems from its exclusive arrangements with USWC and not from its nonexclusive ability to secure listings.

v) USWC argues that it did not waive any rights by conceding imputation until further order because an agency does not have the power to define the scope of its own authority (In re Consolidated Cases, 123 Wn.2d 530 (1994)). The Commission rejects the argument. USWC had every opportunity to litigate and every right to appeal the Commission's order in U-89-3524-AT. It did not, and it now concedes that the order provided that directory revenues will be imputed unless and until altered by subsequent order.

vi) USWC argues that the agency gets its power from the legislature, "not from extracting agreements from regulated companies on pain of denial of that to which they are entitled by law." [Emphasis added; USWC Revenue Requirements brief, p. 9]. The Commission rejects the argument. There is no evidence that the Commission or Commission Staff or anyone else extorted something in a way that was improper. On the contrary, the agreement appears to have been entirely voluntary.[24]

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[23] RCW 34.05.530 reads as follows: Standing. A person has standing to obtain judicial review of agency action if that person is aggrieved or adversely affected by the agency action. A person is aggrieved or adversely affected within the meaning of this section only when all three of the following conditions are present:

(1) The agency action has prejudiced or is likely to prejudice that person;

(2) That person's asserted interests are among those that the agency was required to consider when it engaged in the agency action challenged; and

(3) A judgment in favor of that person would substantially eliminate or redress the prejudice to that person caused or likely to be caused by the agency action. (1988 c 288 § 506).

[24] The Commission addresses all of the Company's arguments presented as to yellow page revenue imputation, even though many of the arguments are repetitious of matters previously argued and decided, and others are so patently silly that they insult the Commission's intelligence. USWC's argument that in effect alleges extortion, however, is shocking and outrageous. USWC presented not one iota of evidence supporting this claim. The Company's record of litigation before this Commission and in the courts demonstrates clearly that it knows how to secure redress speedily and successfully if it believes that its interests are adversely affected. If extortion occurred, unbeknownst to the Commission, we call on the Company to bring forward that

11. USWC contends that the Staff is wrong, and the Tunney Act proceedings[25] didn't set the policy that directory earnings should defray local service. The Tunney Act case was only to determine whether the consent decree was consistent with the public interest under antitrust principles. The decision only contemplated that directory revenues would offset local exchange costs, and did not authorize or require that to happen. The Tunney Act decision ruled improper a provision in the Modification of Final Judgment (MFJ) that Regional Bell Operating Company (RBOCs) be excluded from directory publication. Other than that, the decision was dictum.

The Commission rejects this argument. While the decision clearly did not specifically order imputation, there is nothing in the decision that would support USWC's position or indicate any judicial impediment to imputation. On the other hand, imputation is a logical and appropriate consequence of the decision.

12. The Company contends that Staff's suggestion that the Company be required to pay competitors the amount of the imputation is beyond the Commission's statutory power and illustrates the need to end imputation.

The Commission does not accept the Staff suggestion. It would appear to raise substantial issues that are not necessary to decide and that the Commission does not choose to address in this proceeding.

13. The Company argues that Staff and Public Counsel/TRACER are in error in assuming that the future will forever replicate the past, and that the state has the power to seize profits of non-utility affiliates.

The Commission rejects this argument. The Company mischaracterizes the Commission Staff and Public Counsel/TRACER positions and the result of the proposed action. Neither never-ending imputation nor seizure of income is contemplated or attempted here. The profits of non-utility affiliates are not touched in any way. They are merely imputed to USWC, as is permitted by law.

14. USWC contends that MRG does not have a monopoly and its return isn't inconsistent with competitive returns in the advertising business. It argues that there is no evidence that USWC's association with USWD leads people to advertise in the directory. The directory does not use public right of way or eminent domain power of the utility. Imputation conflicts with RCW 80.36.300, encouraging diversity of supply.

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evidence so investigation and possible prosecution can occur. Without that evidence this accusation has no place in a professional presentation.

[25] United States v. Western Electric Co., 552 F.Supp. 131, 148 (D.D.C. 1982), Aff'd. sub nom Maryland v. United States, 460 U.S. 1001 (1983).

The Commission rejects this argument. MRG's possession or lack of a monopoly in the directory market does not appear critical to the imputation decision. The Commission finds that USWC's association with MRG is a benefit to the directory, based on the testimony of Staff and Public Counsel/TRACER witnesses and its mention as a benefit by more than one "public" witness. No one is contending that the directory uses public right-of-way or powers of eminent domain. No party is contending that the law of right of way or eminent domain support imputation of directory revenues. Imputation has nothing whatsoever to do with diversity of supply as it imposes no restrictions whatsoever upon diversity.

15. USWC contends that the proposal violates USWC's constitutional rights. that Staff's proposal to pay customers of other carriers is confiscatory and that treating USWC differently and more harshly than other carriers is discriminatory.

The Commission rejects USWC's arguments. Staff's proposal to fund customers of other companies is not accepted. USWC is treated fairly, based upon USWC's unique circumstances . There is no impermissible discrimination. See, Oregon P.U.C. v. Pacific Northwest Bell Telephone Co., Docket UI-54, Order 88-488 (May, 1988).

16. The Company contends that imputation contradicts the general purpose of regulation, which is to simulate the result of an unregulated market. An unregulated business would never subsidize a less profitable line with a more profitable line.

The Commission rejects this argument. The Company cites only one of the underlying principles of regulation. It is also a recognized principle that the Commission must regulate in the public interest.[26] Utilities, operating as natural monopolies, may have the power to operate for their own corporate interests, adversely to the interests of ratepayers. The Commission is charged with protecting the ratepaying public. One of the Commission's functions has been has been to protect customers of noncompetitive services from utilities' self-dealing. Utilities may have the power to subdivide the integrated utility operations and divest for their own organizational goals or profit objectives any discrete, divisible, and potentially profitable aspect of that operation. Imputation is entirely consistent with the purpose of regulation as a tool to minimize adverse effects on such division and divestiture when those circumstances occur.

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[26] RCW 80.01.030 reads in part as follows: The utilities and transportation commission shall:

* * * *

(3) Regulate in the public interest, as provided by the public service laws, the rates, services, facilities, and practices of all persons engaging within this state in the business of supplying any utility service or commodity to the public for compensation, and related activities; including, but not limited to, . . . telecommunications companies . . .

17. USWC argues that the Telecom Act says USWC must allow resale at wholesale rates, discounted from retail rates. This means, it says, that the imputation subsidy for consumers would flow to the resellers who compete with USWC. Imputation denies USWC equal protection.

The Commission rejects this argument. Imputation will not benefit resellers, as the critical issue for resale is the spread (the difference between USWC's retail rate and the wholesale rate at which a reseller purchases it) and not the base on which the spread is calculated. The Commission is not, in any event, "crediting" imputed sums to any class of ratepayer.

18. The Company argues that imputation here is arbitrary and capricious. It cites WUTC v. Washington Natural Gas Co., UG-920840 (4th Supp. Order), contending that there, the Commission rejected Public Counsel's suggestion to attribute merchandising revenues to regulated activities. The Company states that the Commission is arbitrarily treating USWC differently from WNG.

The Commission rejects the Company's arguments. USWC miscites this order. In the cited order, the Commission was directing WNG to provide sufficient information to assure the Commission that operations were segregated and ratepayers were not subsidizing merchandizing operations. The Company has also cited, so is aware of, the statute preventing the Commission from attributing merchandise sales revenues to regulated operations.

Having found the appropriate calculation of the adjustment, and concluding that the Commission has the power to make the adjustment, the final question is whether the adjustment should be ordered.

The Company argues that it is inappropriate to subsidize exchange rates in a currently competitive market, and that the subsidy proposed by staff and Public Counsel/TRACER will stifle any potential competition. The Company argues that USW Direct does not have a monopoly, and identifies numerous other directories published in the state of Washington. We have noted above that whether or not the directory company has a monopoly in directory marketing is not critical to the decision. We find that it certainly has advantages through the relationship between these affiliates that other directory companies do not have. We note Mr. Brosch's comment that no competitor for local exchange service has ever complained about imputation. We find that imputation is not shown to affect adversely any competition for local exchange service, although we commend USWC for being an advocate on behalf of potential competition. We reiterate that in any event we do not attribute imputed revenues to any customer class.

In making this decision, we also consider the unchallenged fact that the vast majority of USWC's 15 jurisdictions also impute directory revenues. We note USWC's concession on brief that the matter was decided in a prior order. We note (1) Mr. Brosch's testimony that US WEST Direct grossed approximately a billion dollars and earned a return of

205% in 1994, (2) his contention that for Washington operations it earned 229%, and (3) his contention that US WEST Direct's return on equity has exceeded 150% every year since 1989, when publisher fees ended. We find that the segregated US WEST Direct operation did in fact earn substantially more than the authorized utility rate of return on its investment.

We note that an integrated operation would consider those revenues from ratepayers as a part of its operating income. Divesting that operation therefore hurts ratepayers substantially, and should not be done unless protections are in place for ratepayers. Here, imputation provides that protection.

Another analysis supports imputation, as well. The divestiture of a money-producing element of integrated operations so closely related to service without a return benefit appears to have been manifestly imprudent. See, WUTC v. Puget Sound Power & Light Co., Docket Nos. UE-920433/920499/921262 (Consolidated), 19th Supp. Order (Sept., 1994). This adjustment could also be supported on the basis of a prudence analysis.

C. Service Quality

Service quality issues are addressed in Part Three of this Order.

III. Operating Expenses

The next general area for study is operating expenses, that is, an examination of the Company's reported expenses in conducting its regulated operations. Ten different areas are in dispute. These adjustments may also have a rate base component; when that is true the adjustment will carry through to rate base in the accompanying table under the same adjustment number.

A. Restructuring PFA-9

During the test period, the Company was conducting a four-year restructuring program, reducing the size of its workforce and reducing the number of customer centers from 560 to 26. It expects substantial savings from the program over time. Most of the costs relate to personnel downsizing -- costs of early retirement and severance. The Company took a one-time pre-tax write-off of $880 million in 1993 relating to restructuring costs financial statement purposes. The Company proposed, then withdrew, an adjustment for this activity.

Commission Staff and Public Counsel/TRACER propose adjustments. They point out the experienced expenses do not represent the ongoing expense level and that the substantial expenses of the program occur in its first three years, while the savings are continuing. They contend that it is improper for ratepayers to pay the expenses in rates, but not receive the benefits of lower expense levels. Commission Staff witnesses Ms. Strain and Ms Erdahl propose that the test year costs and benefits be netted and adjusted out of the test year. That would allow the Company test year benefits. Public Counsel/TRACER witness, Mr. Carver, would remove the test year costs but leave test year savings. Public Counsel/TRACER contend that the Company proposal would not present any of the ongoing savings to be derived from the restructuring costs when benefits will exceed costs in 1997 and thereafter.

The Commission rejects the Company's position that no adjustment is appropriate. The evidence demonstrates that during the test period, costs of implementing the restructuring were greater than any benefits derived. This net cost is embedded in the test year actual results. The Company's stated purposes for the restructuring is to reduce costs and increase efficiency. There is no evidence that efficiency and quality of service are increased. It is inappropriate to include the net cost of restructuring in the test period when on an ongoing basis the Company projects that there will be net savings with an internal rate of return greater than the Commission's authorized return. Commission Staff's position, which treats results as if the restructuring did not take place, is fair. Public Counsel/TRACER's position, which attempts to leave net savings in the test period, cannot be verified. Further, to the extent that savings exist in the future, they will be present in the Company's results and if we continue traditional ratemaking, should be returned to ratepayers through lower rates.

The Commission accepts Commission Staff's adjustment PFA-9 and rejects Public Counsel/TRACER adjustment relating to restructuring. This adjustment increases net operating income by $11,408,953 and decreases rate base by $11,766,524.

B. OPEB Curtailment Loss, Adjustments PFA-10

The Company's proposed adjustment restates the effects of restructuring on "Other Post Employment Benefits." Under Statement of Financial Accounting Standards (SFAS) No. 106 of the Financial Accounting Standards Board, a Company is required to recognize a curtailment loss or gain when the Company experiences any event which significantly alters the expected years of future service of active participants. The present value of post-employment benefits is recorded as an expense at the time they are accrued, in order to reflect the Company's long-term obligation. The obligation is valued on the basis of statistical averages of employee service before separation or retirement.

Because the restructuring program resulted in a large number of early retirements -- some 2,200 -- the average future service of Company employees dropped during the test year. As a result, the Company booked a curtailment loss in 1994. The Company proposes an adjustment to reflect the curtailment loss during the test period.

Commission Staff and Public Counsel/TRACER oppose the Company adjustment, contending that the restructure is a one-time event and that savings from restructuring will more than cover additional expense.

The Commission accepts the Commission Staff argument. It finds that the restructuring is a one-time event and that restructuring savings will offset any additional costs. It acknowledges, as the Company argues, that the Company is required to make the adjustment for financial accounting purposes. In accepting the Commission Staff adjustment for restructuring, above, we did acknowledge that savings would grow and expenses would fall, and that savings would thus exceed expenses. That excess, we reason, offsets the proposed adjustment. Therefore we reject the Company's proposed adjustment.

C. Jurisdictional Separations

Washington ratepayers are responsible only for Washington-related expenses and costs. Because the Company operates and uses its facilities in providing interstate communication, the total costs associated with the Company's operation are allocated or "separated" between Washington (intrastate) operations and the Company's interstate operations. The Company results reflect the monthly allocations during the test period.

Commission Staff noted that during the 14 months of information available on the record, intrastate allocation factors trended downward and interstate factors trended upward. Commission Staff contends that because the intrastate allocation factors are trending downward, the test period is not representative of ongoing factors. They contend that their review of Exhibit 722 clearly indicates that trend, which requires the increased allocation of costs to the interstate jurisdiction.

The Company contends that this is error, that there is no reason to support the change except a lower revenue requirement, and that use of a test period is designed to account for such variations. They also contended in a data response that rather than trending, the separations figures are merely "fluctuating."

A test year is used to compare relationships over time for an accurate picture of Company operations. However, when the test year average is inaccurate, it is appropriate to make such adjustments as needed to produce an accurate picture.

Here, Exhibit 722 clearly shows a trend rather than a fluctuation. The Commission finds that the relationship between interstate and intrastate operations has changed, and the relationship during the period that rates resulting from this proceeding may be expected to be effective is more accurately represented by use of the December figures rather than the test year monthly figures. The Commission Staff adjustment is accepted. This shows an increase to net operating income of $6,805,250 and a decrease to net rate base of $35,722,831.

D. External Relations SA-11

This adjustment is made to remove expenses related to company corporate image advertising and related External Affairs supervision. Commission Staff witness Mr. Hua proposes to remove the corporate or image advertising that was not part of Staff's affiliated interest adjustment RSA-5. He also proposes to disallow an allocated share of the supervision in the external relations department. Mr. Hua's original adjustment disallowed substantially more of the costs in the nine categories in this department. He revised his adjustment based on information that the Company eventually supplied.

Ms. Wright rebuts Mr. Hua's adjustment. She argues that public policy type work functions are a necessity in a regulated environment. Her rebuttal testimony (pages 50-52) gives a description of costs included in each of the 9 categories. She states that only one category should be removed from regulated results, and that the Company has removed those costs.

The Commission accepts the Commission Staff proposed adjustment to remove the image advertising but not the allocated supervision. There appears to be little contest as to the specifics of the advertisements in question. Corporate image advertising is not shown to benefit the ratepayers. It is appropriately disallowed in telephone rate cases.[27] The amount of the adjustment to net operating income is $338,911.

E. Promotional Advertising, SA-8

In this adjustment, Commission Staff proposes to disallow $6.3 million in product advertising, contending that the Company has failed to demonstrate that the advertisements generated more revenues than they cost.

The Company responds that this test has never been applied before. Citing an order in WUTC v. Pacific Northwest Bell Telephone Co., Cause No. U-77-87, the Company contends that the appropriate test remains whether advertising encourages the purchase of services that provide a contribution above expenses. To the extent that it does so, says the Company, it should be allowed.

The Commission finds that the advertising in question is directed toward products that will provide a contribution above expenses. Staff does not contend and has not argued that the advertisements were imprudent, unreasonable, wasteful, disproportional to revenues, or flawed in any way -- only that the Company has not demonstrated that they worked by bringing in more revenues than the ads cost.

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[27] See, e.g., Re Illinois Bell Telephone Co., 156 PUR4th 121, 193-194 (1994).

We do not think that is the proper test. Revenues may be difficult to attribute; results may not be immediate. The decisions from other jurisdictions cited by Commission Staff do not support the principles for which they are urged, and the suggested standard is not shown to be appropriate. For these reasons, we reject the Commission Staff proposed adjustment.

F. Interconnection with Independents, PFA-11; C-2

This adjustment related to local exchange interconnection. The parties agreed that the adjustment would be resolved by judicial review of Commission Docket No. UT-941464, and the Company withdrew the adjustment.

G. Compensation Issues

1. Wages and Salaries: RSA-1 and -2; PFA-1 and -2; SA-12; B-2; C-11; C-12; and C-14

The Company proposed several adjustments to payroll expense to pro form the impact of wage or salary increases during or after the test period. Adjustment RSA-1 pro forms the impact of wage increases during the test year for occupational (non-management) employees. RSA-2 pro forms salary increases for management employees that were implemented during the test period. PFA-1 pro forms the impact of a wage increase for occupational employees subsequent to the test period. PFA-2 pro forms salary increases to management employees subsequent to the test period. The Company's proposed adjustments pro form both the operating expenses and the rate base for these increases.

Ms. Erdahl, Staff's witness, states that the test period wages are not representative, in that they contain excessive overtime and an abnormally low level of capitalization. Ms. Erdahl proposes adjustment SA-12 to decrease the level of overtime from that experienced during the test period and to capitalize a greater portion of the total salaries incurred during the test period, reducing test period operating expense. Ms. Erdahl 's normalized levels for overtime and capitalization are based on a two-year average for overtime and a four year average for the capitalization percentage. Ms. Erdahl revised the Company's pro forma adjustments to give effect to her overtime and capitalization adjustment.

Ms. Erdahl also proposes to exclude team and merit awards from base wages used to calculate RSA-1 and -2 and PFA-1 and -2. She argues that these payments are discretionary. She identifies previous Commission orders excluding bonuses from base wages in pro forma calculations. Finally, she proposes to exclude the rate base impact of the Company's proposed pro forma adjustments. Commission Staff argues that it is inappropriate to pro form rate base, citing prior Commission order on the topic.

Public Counsel/TRACER sponsored witness Carver. The witness objects to the Company's presentation on the basis that it is imbalanced. He contends that the Company pro forms wage rate increases when total payroll costs are declining. As a result, he proposes to reject the Company's PFA-1 and -2 adjustments. He also would reject the rate base impact of adjustments RSA-1 and -2. As does Commission Staff, he contends that the rate base adjustments pro form the effects of "costs" that will never exist. Finally, he proposes adjustments C-11 and -12, to annualize the last quarter of 1994 payroll in lieu of the Company's pro forma payroll.

The Company contends that the Commission Staff and Public Counsel/TRACER adjustments are arbitrary and capricious, and offered without evidence to support normalization.

The Commission in general accepts the Company's presentation on these adjustments. The Commission rejects Commission Staff's proposed adjustment to decrease overtime and increase the capitalization percentage. As Ms. Wright testified (Ex. 154), the use of overtime is a management tool. There appears to be no contention that the Company misused that tool. Further, there is no evidence that the increased level of capitalization, if appropriate, would correspondingly result in lower wage expense.

The Commission also rejects Public Counsel/TRACER proposed annualization adjustments. The Commission is not convinced that the end of the year employment is representative of the ongoing level of employment in this proceeding, and believes that the Company presentation reflects a satisfactory relationship.

The Commission does accept Commission Staff's proposal to remove bonuses from base wages in the calculation of pro forma wages. The bonuses are discretionary, and are not certain at any level. Further, as discussed later in this Order, the Commission rejects the Company's Team and Merit Awards.

Finally, the Commission agrees with Commission Staff and Public Counsel/TRACER that it is inappropriate to pro form rate base for the wage increase. Such pro forma rate base adjustments would increase rate base for amounts that will never be incurred. Such pro forma rate base adjustments would result in increases to the entire rate base for increases in the unit cost of the components. This type of restatement would run counter to the industry's actual historical experience of declining costs.

The Commission has recalculated the pro forma payroll adjustments based on the above discussion, as follows: Adjustment RSA-1 decreases NOI by $1,972,844; Adjustment RSA-2 decreases NOI by $747,663; Adjustment PFA-1 decreases NOI by $3,381,860; and Adjustment PFA-2 decreases NOI by $1,482,081.

2. Compensated Absence Adjustment, RSA-12

The Compensated Absence adjustment has to do with paid leave, such as sick leave. The Company books estimated figures monthly, then makes true-up adjustments to make the test year accurate. In this adjustment, the Company proposes to adjust the test year expense to the actual amount incurred during that year. Commission Staff contests the adjustment, contending that it is selective and to the ratepayers' detriment. Commission Staff argues that the monthly accrual amounts represent a more appropriate "going forward" amount. Staff adjusts test year expense to this level.

Here, the Commission accepts Ms. Wright's representation that the true-up adjustments are accurate, and accepts the test year employment level as sufficient for regulatory purposes. The Commission accepts this Company-proposed adjustment, which reduces NOI by $390,000.

3. Team and Merit Awards/TPA, RSA-13

a. Team Awards

During the test period, the Company awarded employee bonuses called Team Performance Awards based on Company performance. The total award was based on customer service measures; quality indicators; Company net income; and business units. During 1994, no payment was made for the service quality component. The Company, through Ms. Wright, proposes adjustment RSA-13 to restate this expense to the level paid for the test period.

Commission Staff proposes to disallow the team and merit awards. Ms. Erdahl's presentation makes it clear that a portion of the awards were accrued for customer service and quality indicators (Ex. 670); Commission Staff witness Beaton proposes that these amounts should be disallowed. The remaining $5.9 million allocated to Washington intrastate operations are awarded based on USWC net income and business unit results (see Ex.662, p. 25). Ms. Erdahl states that these awards, based on USWC results, do not benefit the Washington ratepayer.

Commission Staff argues that the Company has not demonstrated that the events that raise net income benefit the ratepayers. Commission Staff states that net income and customer service are often at cross-purposes with each other, and point to their contention that service quality is deteriorating.

The Company contends that the disallowance should be rejected because it is contrary to the evidence; contrary to well-established precedent; and contrary to sound compensation practices. USWC witness Paul Gobat contended that the Team and Merit awards are an integral and significant portion of management wages for USWC. He states that USWC compensation is reasonable -- in fact, lower than the market average. He states that awards based on net income are beneficial to ratepayers, and that 50% of the scheduled awards were based on quality indicators and customer service. Ms. Wright also addresses this issue and presents a sample of how the team awards are granted. She states that goals related to net income are beneficial to ratepayers because the increase in net income is created by employees working to reduce costs, and reduced costs result in reduced need to increase rates.

The Commission finds that the team and merit awards have not been shown to benefit the ratepayer, and accepts the Staff-proposed adjustment. As the Company notes, award programs have been accepted as proper expenses for ratemaking purposes by this and other public utility commissions. This Commission has observed that management should have the flexibility to reward good performance and productivity increases[28] and has accepted a program that it observed was not perfect.[29] In the latter proceeding, however, the Commission gave a clear message as to its view of the purpose and structure of an allowable plan:[30]

> The Commission does agree with Staff that some of the (Washington Natural Gas Company) incentives fall short in terms of sending employees the message that the purpose of the program is to encourage improved service. The Commission believes, however, that the Company can do a far better job in the future of creating incentives and setting goals that advantage ratepayers as well as shareholders. Such goals might include controlling costs, promoting energy efficiency, providing good customer service, and promoting safety. <u>Plans which do not tie payments to goals that clearly and directly benefit ratepayers will face disallowance in future proceedings.</u> (Emphasis added.)

In the USWC plan, only a portion of the incentives were directly tied to service or service-related elements. The service goals were not met and that portion was not distributed. The income-related portion, however, was met and exceeded. What is particularly objectionable about this plan is not only that the financial incentives were independent of the service incentives, but the program was constructed so that, if the Company exceeded the stated financial goals by only 8%, employees could "replace" all of the bonus that they would "lose" for failure to achieve customer service goals (Ex. 189, fourth and twelfth pages).

As the Commission noted in the Washington Natural Gas order cited above, there is a potential tension between service quality and earnings. A firm can concentrate on financial elements so heavily that it can lose sight of the importance of providing customer service. In a public utility service, where many customers have no reasonably substitutable alternatives, the

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28 WUTC v. Pacific Power & Light Co., Cause No. U-86-02 (1986).

29 WUTC v. Washington Natural Gas Co., Docket No. UG-920840, 4th Supp. Order (1993)

30 Id., page 19.

Commission must substitute for the competitive market in assuring that customer service remains a priority to the business. Financial goals are at best a very crude way to measure specific efficiencies that employees can accomplish.

The Commission finds that the Company's team award plan is not acceptable because, with a structure allowing financial rewards to eclipse customer service failures, it sends the message to employees that service quality is much less important than financial performance. This provides motivation to choose cost saving measures that unduly compromise service quality. The Company plan fails to tie payments to goals that clearly and directly benefit ratepayers. The Company's service quality clearly failed to meet acceptable standards during the test period, as discussed above, while the Company exceeded its financial goals. Whether or not the structure of team awards contributed to this circumstance, it is certainly consistent with the circumstance.

Problems with the plan could be corrected in many ways, including the payment of financial performance awards only after service quality goals are met; tying the amount of awards for other indices to service quality performance; or tying financial-based awards not to the bottom line but to objective employee performance that promotes both efficiencies and customer service. For this proceeding, the Commission accepts the Commission Staff adjustment.

b. <u>"Merit" Awards</u>

Commission Staff's proposed adjustment also would disallow merit awards granted to individual employees.

Merit awards to individual employees, which are clearly based on the evaluation of employee performance upon appropriate standards, should not ordinarily be second-guessed or micromanaged by a regulator. The use of merit awards and the fairness of their distribution are matters for the Company to decide and for which it will ordinarily reap the positive and the negative consequences. Here, however, Commission Staff calls into question the standards by which the awards are granted.

The Company presented little evidence about those standards, and there may be inconsistencies within that evidence. Commission Staff notes that Ex. 221 defines merit awards using the same criteria as are used to define the team awards in Ex. 189. Ex. 190 does not distinguish between criteria for the two. Ex. 189 states at page 2 that a portion of the team performance award constitutes "discretionary payouts for individual employees" and the segment entitled "salary adjustments" at page 4 of the attachment to Ex. 189 is the fourth page of a Team Performance Award brochure for employees. The information we have of record, therefore, indicates that the criteria for merit awards are the same as the criteria for the team awards -- or that "merit" awards are a portion of the Team Performance Awards and thus entirely dependent upon the criteria we have identified as faulty. Because we have disallowed team awards for the use of improper standards, we accept the Commission Staff adjustment and disallow merit awards on the same basis.

The effect of the team and merit awards adjustment is to increase NOI by $6,384,966.

4. Benefit Expense, RSA-14

This Company-proposed adjustment restates test year expense levels for true-ups made in November and December, 1994. Commission Staff opposes the adjustment, contending that test year capitalization is not representative. Staff also objects to the Company's restatement of rate base in this adjustment because, Staff contends, it is inappropriate to pro form rate base. Because we have accepted the Company's capitalization adjustment, and because the two are related and rise or fall on the same analysis, we accept the Company's adjustment here. We also accept the rate base portion of the adjustment, noting that the adjustment is restating and not pro forma.

5. Other Post Employment Benefits (OPEB), RMA-8

This Company-proposed adjustment restates test year OPEB expenses to reflect this Commission's prior adoption of accrual accounting during 1988 and 1989. The Company's expense level is based on the amortization of the transition benefit obligation over 17.3 years based upon the recommendation of the Company's actuary. Mr. Twitchell for Commission Staff proposes to extend the term of the amortization to 20 years. He contends that the 20-year period is consistent with SFAS 106. Staff also suggests that because of the early retirements during restructuring, the working lives of remaining employees will be longer, and calendar 1994 figures are more representative of post-period employment.

The Commission accepts the Company proposal. Although the Commission Staff concerns may have merit, the Company has presented sufficient evidence of record to support its adjustment and the Commission Staff proposal lacks sufficient specific evidence to support it. The adjustment increases NOI by $97,331 and decreases rage base by $7,036,298.

H. Regulatory Fee RSA-17-9; SA-9

The Commission Staff proposes Adjustment SA-9 to pro form the Company's regulatory fee to the rate case level and the current regulatory fee rate. The Company challenges the Staff proposal, contending that Commission Staff proposes selective true-ups and that the monthly accruals were reasonable when booked. On rebuttal, the Company does propose a small adjustment to correct test year posting errors.

The Commission accepts the Commission Staff proposed pro forma adjustment. It reflects the proper treatment for rate case calculation, as it will best reflect the relationship between revenues and expenses going forward, and thus constitutes a better basis on which to set rates. The effect of this adjustment is an increase in NOI of $178,182.

I. Amortization of Debt Call Premiums, PFA-8

The parties agree, and the Commission finds, that the cost of call premiums paid when the Company retired high-interest funded debt is a proper expense for ratemaking purposes. The Company agrees that this expense may be recovered either through the Company adjustment or, as the Commission Staff suggests, through the use of long term debt rate reflecting the expense.

The Commission finds it more appropriate to include the amortization of these expenses in calculating the cost of long term debt. The Commission therefore accepts the Commission Staff adjustment and will recalculate the long term debt cost rate consistent with the Commission Staff suggestion to include this expense.

J. Capital Recovery, PFA-6, B-3, C-15

This adjustment relates to depreciation rates. The Company has tried to relitigate recently-decided and litigate soon-to-be decided depreciation matters in this proceeding, and the Commission has declined to do so. The Company challenges that refusal, contending that it illegally harms the Company.

The Commission acknowledges that the use of accurate depreciation rates is an important element of ratesetting. The Commission reiterates its prior rulings, however, that it need not relitigate the recently-decided depreciation methodology and rates that the Company sought to support in this proceeding with virtually the same evidence -- word for word -- that the Commission considered in the just-completed interconnection proceeding.

The Commission has also noted that the triennial represcription of lives, involving the Commission, the FCC, and the Company, is underway. It is a consideration of some depreciation elements. Upon conclusion of the represcription process, the Commission will consider adjusting rates if doing so is procedurally appropriate and consistent with regulatory principles.

The Commission sees no reason now to reverse its prior rulings on this matter.

We do note that Commission Staff has prepared a pro forma adjustment to implement the depreciation rates found appropriate in Docket No. UT-940641. The Company does not contend that Mr. Spinks' calculation is in error. The Commission will adopt Commission Staff's pro forma adjustment to depreciation expense and accumulated depreciation. The effect of the adjustment is an increase in NOI of $5,049,375 and an increase in rate base of $1,165,240.

IV. Affiliated Transactions

A. General Considerations.

The Company purchases a number of services from companies that are affiliates. Affiliated interest transactions have long been subject to particular scrutiny in utility regulation, both in this state and in other jurisdictions. A company might be tempted to divert functions to unregulated affiliates so that stockholders might earn a higher unregulated return from the affiliate than they might from a regulated entity, with ratepayers consequently responsible for higher expenses than might be experienced in an integrated regulated company. Courts also point to the lack of an arms-length relationship between contracting affiliates, and the resulting temptation to avoid hard bargaining that might be available in a competitive environment.

In Washington State, the Commission has consistently used RCW 80.16.030[31] to protect ratepayers from possible harm from affiliated transactions. The regulated company bears the burden of demonstrating that the payment is a reasonable amount; if it does not do so, or if it does not show the cost to the affiliate of rendering service, the Commission is instructed to disallow payment.[32] The standard for a reasonable price is the lower of the competitive market price or the affiliate's costs plus a fair return.[33]

This record presents evidence regarding affiliated transactions with Marketing Resource Group (MRG), to which the Company sells billing and collection services, publisher products, and directory placement at public pay stations; Business Resources, Inc. (BRI), from which the Company purchases procurement, warehousing, and delivery services; with Bellcore

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[31] The statute reads as follows (emphasis added):
80.16.030 Payments to affiliated interest disallowed if not reasonable. In any proceeding, whether upon the commission's own motion or upon complaint, involving the rates or practices of any public service company, the commission may exclude from the accounts of such public service company any payment or compensation to an affiliated interest for any services rendered or property or service furnished, as above described, under existing contracts or arrangements with such affiliated interest unless such public service company shall establish the reasonableness of such payment or compensation. In such proceeding the commission shall disallow such payment or compensation, in whole or in part, in the absence of satisfactory proof that it is reasonable in amount. In such proceeding any payment or compensation may be disapproved or disallowed by the commission, in whole or in part, unless satisfactory proof is submitted to the commission of the cost to the affiliated interest of rendering the service or furnishing the property or service above described.

[32] RCW 80.16.030.

[33] WUTC v. Washington Natural Gas Co., Docket No. UG-911236, Third Supp. Order (Sept., 1992).

and US WEST Advanced Technologies (USWAT), from which it purchases research and development; and with US WEST, Inc. (USWI), from which it purchases various management services.

B. Marketing Resource Group, SA-4 and C-4

The Company receives revenues from an agreement with MRG for services that it provides: billing and collection, publisher products, and directory placement at pay phones. It records some of the revenues that it receives for this service -- cost, including a return -- as operating income. However, when revenues exceed costs, it records the excess revenues below the line, not considering them as income for purposes of regulation.

Commission Staff and Public Counsel/TRACER would make adjustments to consider the below the line revenues for ratemaking purposes. The Company challenges the adjustments and defends its approach, contending that it is merely following accounting practices established by the Federal Communications Commission (FCC) that the Commission has adopted.

Commission Staff and Public Counsel/TRACER contend that the requirement to use FCC accounting for book purposes does not govern accounting analysis for rate of return regulatory practices, noting that the FCC rules do not constrain USWI from incurring costs for image advertising, lobbying, and charitable contributions. Public Counsel witness, Mr. Brosch, noted that the services are part of MRG's costs and are deducted from the imputation, so should be reflected as income to USWC. (Ex. 390-T, p. 111)

The Commission finds no facts, no rationale, and no citations of authority, to indicate that the Company's accounting practice is appropriate for ratemaking purposes. Accounting for book purposes, even pursuant to rules that the Commission has established or adopted by reference, does not control accounting for ratemaking purposes. WAC 480-120-031(1)[34] All the revenues from MRG for those functions should be considered above the line revenues for ratemaking purposes. The revenues relate to a formerly proprietary function, a regulatory asset, that the Company transferred without compensation. Under the Company's proposed treatment, the ratepayers would not only be deprived of the revenues from earnings, but also deprived of the full benefit of payment for services it formerly performed for itself, thus losing twice. The Commission accepts Commission Staff's calculation of the adjustment, virtually identical to that of Public counsel/Tracer, increasing NOI by $1,052,896.

C. Business Resources, Inc. (BRI), SA-7

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[34] WAC 480-120-031 reads in part as follows:
The accounting rules for book and recording purposes do not dictate intrastate ratemaking.

USWC purchases procurement, warehousing, and delivery services from BRI. Commission Staff contends that alternative services are available from other vendors at a much lower cost than USWC paid to BRI. It calculated the affiliate's costs plus a fair return, and it considered the price of alternative resources based upon Company studies. In proposing its adjustment SA-7, it used estimates of market price based upon a 1988 Company study. It proposes an adjustment of $2,374,375 to net operating income based upon its analysis.

USWC challenges the adjustment, contending that the underlying information that Staff uses is out of date and, in any event, that it is entitled to consider non-cost factors such as the affiliate's track record and its understanding of Company procedures. It notes that the Commission as a State agency is entitled to consider non-cost factors in its procurement.

The analogy with Washington State procurement requirements is not well-taken. The issue is not whether the Company is entitled to enter a contract with an entity other than the lowest bidder. The Commission acknowledges that the Company can lawfully enter a contract for services with virtually whomever it chooses -- in most circumstances with limited Commission review. That is a management prerogative with which the Commission is loath to interfere. The question here is not entry of a contract, but allowance of expenses for ratemaking purposes. The contention that BRI is better because of its history with the Company is entitled to little weight because any contractor might be expected to develop a track record and understanding of Company procedures if given the opportunity. The Company provides no objective evidence demonstrating BRI's superiority or justifying the additional expense. Nor, as the Company appears to allege, is the issue whether BRI overcharged USWC.

Instead, the issue is the financial consequences of such a contract and whether payments under the contract are reasonable by the objective standard stated above.[35] Here, we find that the Company has not demonstrated that the payment is reasonable under pertinent standards.

The Company challenges use of the 1988 study as outdated, contending that it fails to provide an accurate picture of market prices and that its 1990 study is better. Commission Staff responds, and we find, that the 1990 study is flawed and appears to contain double loadings. Therefore, it should be excluded.

The Commission accepts the Commission Staff use of the competitive bids for purposes of pricing the affiliated interest transaction.[36] The Commission finds the testimony of Ms. Strain credible in support of this adjustment.

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35 Commission Staff does not allege that the contract payments are imprudent.

36 Use of comparable prices requires considerable judgment. Comparable prices are based on estimates that the Company gains from businesses who may look at the relationship between USWC and BRI, as well as the history of the contractual relationship, and perceive that they have no realistic chance of securing USWC 's business.

In conclusion, because the transaction is with an affiliate, the Commission may look to the lower of the affiliate's costs or the market price for comparable services to establish the reasonableness of the charges. Here, the credible information as to market prices is the 1988 study and Ms. Strain's testimony. USWC contends that it is entitled to recognition of higher payments because it believes BRI provides better service than a low bidder might, but it provides little evidence beyond conclusory statements that BRI knows a great deal about USWC's business. The burden of proof to justify affiliated interest transactions is higher than such bare allegations.

D. Research and Development, SA-7, C-6, C-7, and RSA-10

No party challenges the generic propriety of research and development expenses for the Company's operations. It must continually look to the future and to its need to maintain its position as a leader in technology, both as an element of its service to present customers and as an element of its preparation for a fully competitive environment.

The issue instead is whether and to what extent ratepayers should fund the activities. Courts have acknowledged the appropriateness of disallowing projects that are unlikely to provide ratepayer benefit[37] or have required a strong showing of benefit to ratepayers in the near future and have categorically disallowed "fundamental research."[38] The parties look to specific elements of the transactions with the two R & D suppliers, Bellcore and USWAT to determine whether the item should be allowed or disallowed.

Commission Staff notes that the Company allocated costs between regulated and unregulated activities by the size of the entities and not the purpose or benefit of the project. Commission Staff reviewed the payments, and proposes to disallow many of the expenses and to expense others over their useful life. Staff proposes to disallow 50% of the costs of a number of research projects which, it argues, have deliverable commonalities. Staff criteria for decision included whether an individual project had benefit to Company operations that are now deregulated or that provide no perceived benefit to current ratepayers for regulated tariff service. (Ex. 631-T, p. 17).

Public Counsel/TRACER witness, Mr. Brosch, discusses the costs associated with research and development by USWC affiliates U S WEST Advanced Technologies (USWAT) and Bell Communications Research, Inc. (Bellcore) on page 63 of his testimony. The projects he removed dealt with multimedia services, future video, and broadband and wireless network technologies. As does Commission Staff, he finds that many of the projects undertaken by these affiliates do not have current ratepayer benefits. Many of the projects either extend to

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[37] See, Re USWC, 142 PUR 4th 1, 29-31 (Utah P.S.C., 1993.

[38] See, Re AT&T Communications, 107 PUR4th 381 (La. P.S.C., 1989).

nonregulated activities or relate to services far beyond the potential of current telephone technology. His disallowance proposals suggest that if at some future time the Company can demonstrate that these projects do benefit ratepayers, they should be allowed to request recovery of the costs with interest. A side record would be kept to track potential future recovery. As documentation he provides Exhibits 394, 395 and 396 to show descriptions of the contested projects. On rebuttal, he states that his adjustments on Bellcore, USWAT, and the parent vary from staff's mainly on the basis of scope. He believes his position to be more conservative than that of Commission Staff.

Public Counsel/TRACER argue that research and development costs should be recovered only if reasonable. They identify four issues that must be resolved to determine reasonableness: Is there a mismatch of cost and benefit? Do unregulated operations benefit? Is there subsidization of business risk? and, Is the research unsuccessful? Public Counsel refer to a Utah order, which required deferral of certain portions of these costs.

US WEST cites WUTC v. Puget Sound Power & Light Co., 74 PUR 4th 536, 576, 577 (1986) for the proposition that there is necessarily a lag of time, perhaps years, between the investment in research and development and the realization of benefits, and that the Commission considers research and development investment to be socially beneficial, valuable to ratepayers, and pertinent to the Company's needs. USWC contends that it is similarly situated. The Commission disagrees. Differences include the relationship between the contracting parties -- in the Puget case the research was provided by a non-affiliated entity, EPRI (Electric Power Research Institute). Factors also include the nature of the industries; at the time of the order, electric companies were fully regulated and there was no hint that elements would be deregulated. Here, many aspects of telecommunications are deregulated, others are subject to substantial deregulation, and the future appears to hold the promise of additional deregulation. The Commission finds, as pointed out by both Commission Staff and Public Counsel/TRACER witnesses, that it is a very real concern that telephone company ratepayers of regulated services could be charged for research benefiting only the Company or users of deregulated services. While the Commission still subscribes to the basic principles in the Puget order, and will allow costs for projects that appear to have value for ratepayers, the language in Puget cannot be uncritically applied to justify any expense, however unrelated to regulated operations.

The Company contends that it is impossible to determine now what activities might be deregulated in the future by the legislature; that all but a few are now regulated; and that all of the research will be beneficial to ratepayers. It contends that the deferral suggested by Public Counsel/TRACER is unauthorized by law and that future recovery is illusory because single issue ratemaking and retroactive ratemaking are not permitted.

The Commission accepts the Public Counsel/TRACER approach to both Bellcore and USWAT. We prefer it to Commission Staff's similar approach because it is more clearly documented and offers long-term opportunity for recovery. We find no legal bar to using a side record for potential recovery. We find that it is specific as to project, so that benefit will be simple to determine. The approach will allow the Company to recover the costs of many projects immediately and will allow the full recovery of all deferred projects that prove beneficial to regulated operations -- in a manner that is not retroactive ratemaking, but that allows recovery on a prospective basis when benefit is determined. USWC does not demonstrate that the approach is improper, and side records may, as here, be entirely appropriate for ratemaking purposes.

Accepting the Public Counsel/TRACER adjustment C-6 increases net income by $606,000. Public Counsel/Tracer adjustment C-8 increases NOI by $286,000. Finally, as part of Public Counsel/TRACER presentation, we adopt the company proposed adjustment RSA-10, which increases NOI by $711,913.

E. US WEST, Inc., Adjustments RSA-5A, RSA-5B, and C-8

US WEST, Inc. (USWI) is USWC 's parent and an affiliate of USWC. USWI provides substantial management services to USWC and USWI's other subsidiaries. As listed in Mr. Brosch's testimony, Ex. 390-T, page 39, the services include shareholder services; executive management; treasury; legal; strategic marketing; strategic planning; corporate finance; and accounting.

USWI charges USWC for the services that it provides. USWC has recorded these charges as operating expenses, and in adjustment RSA-5 it proposes to true up expenses occurring within the test year but recorded afterwards.

Commission Staff contends that some of the amounts that USWC pays to USWI are improper for ratemaking purposes. Ms. Erdahl does not object to the Company's adjustment, but modifies it to eliminate charges for certain functions provided by USWI: executive management, human resources, public relations, and strategic planning. She contends that the USWI executive management and human resources services overlap functions performed by USWC management (Ex. 272 and 273) that are needed only because USWI is running many corporate entities. It contends that USWI's focus is on the integration of USWC with the USWI "family" and that if USWC were a company standing alone, those functions would not be necessary. The Company has its own executive management and public relations departments, Staff argues, and if USWC were an independent company the USWI functions would be unnecessary. Functions performed by USWI are largely related to unregulated operations, competitive services, support of the parent corporation itself, or are simply not needed because USWC has its own staff able to perform the functions. In addition, Commission Staff has also proposed disallowance of strategic planning involving all USWI subsidiaries and focusing on the future of USWI policy positions nationally and internationally, largely in non-regulated areas, and costs related to corporate image advertising and public relations because the Company has not provided sufficient information to demonstrate that any amount of corporate image advertising benefits ratepayers.

On behalf of Public Counsel/TRACER, Mr. Brosch proposes adjustment C-8 to disallow executive management and image advertising costs. He also notes redundancies but not exact duplication of functions between the two affiliates. Instead, Public Counsel/TRACER contend that the holding company imposes some costs that would not be necessary if there were no holding company and that USWC hasn't demonstrated that some of the USWI costs are appropriate for intrastate regulated operations. Mr. Brosch provides a list of services provided by USWI to USWC and states that costs of the new, fast-growing, non-regulated business should not be included in rates for regulated services. He discusses the Regulatory Impact Review (RIR) that was performed in connection with the 14-State Regional Oversight Committee (composed of state commissioners and staff in USWC's service territory), indicating that the review was not intended to take the place of regulatory oversight and did not make recommendations. Public Counsel/TRACER also argue that allocations based on relative affiliate size shifts costs inappropriately to regulated operations because much of the USWI focus is on non-regulated activities. Public Counsel/TRACER contend that the institutional or image advertising fails to provide a direct and primary benefit to the regulated subsidiary.

USWC argues that the Commission Staff and Public Counsel/TRACER adjustments are inappropriate. It contends that the Commission Staff and Public Counsel/TRACER positions are based on duplication of functions, and urges that there is no duplication. USWC also contends that the image advertising does promote the growth of the business and therefore should be allowable.

The Company arguments do not directly address the Commission Staff and Public Counsel/TRACER positions. Based on the evidence, the Commission finds that the USWI functions are not entirely duplicative of USWC functions, but that there is substantial overlap and that the challenged USWI functions are directed principally toward "family-wide"' matters rather than USWC issues. USWC has not demonstrated that the overlapping services are reasonable charges to the regulated subsidiary or that they are charged in proportion to the benefits received by the regulated subsidiary. If USWC were a nonaffiliated company, it does appear from the credible testimony of record that those functions could be performed by USWC existing staff or would be unnecessary.

Neither is the Commission persuaded that the costs of image advertising is appropriately borne by ratepayers. The Company contended as to a prior issue, and the Commission agreed, that the appropriate test remains whether advertising encourages the purchase of services that provide a contribution above expenses. Here, there is no evidence that the corporate image expenses meet that test. The Commission believes that the Commission Staff proposed adjustment more accurately removes inappropriate costs, and the Commission accepts the Commission Staff proposed adjustment, which increases NOI by $1,232,375.

V. Taxes

A. Recalculation of Sharing Adjustment, RMA-9, B-4

The Company operated under an alternate form of regulation or AFOR for several years. One element of the AFOR was the sharing of excess earnings. Under that program, the Company and ratepayers shared the benefit of excess earnings according to a prearranged formula. The process was called Sharing and the ratepayer interest was called Sharing Dollars. The Commission designated the distribution of the ratepayer share, and during 1990, 1991, and 1993 used a portion as a credit to depreciation. Under the AFOR settlement, the Company was required to credit accumulated depreciation for an equal portion of the Company's share of excess earnings.

Company witness Ms. Wright proposes adjustment RMA-9, Sharing Adjustment, to give effect to the disposition of sharing dollars through the depreciation reserve for the sharing orders for 1991 and 1992. Her proposed adjustment includes an offset to accumulated depreciation for accumulated deferred taxes. The Company adjustment does not include sharing dollars allocated to accumulated depreciation for 1993.

Commission Staff witness, Mr. Twitchell, discusses the sharing adjustment. His adjustment modifies the Company's adjustment in two respects. First, he includes the 1993 sharing order, which had not been resolved at the time of the Company's filing. The Commission finds this a proper fro forma adjustment to give effect to the 1993 distribution of sharing dollars. The Company did not accept this adjustment but included only 1991 and 1992 sharing results in its presentation and did not address the issue in its brief. Including the 1993 sharing distribution is an appropriate pro forma adjustment and the Commission accepts it.

Second, Mr. Twitchell did not give effect to deferred taxes as the Company proposed. Commission Staff argues that the proposed adjustment to accumulated deferred taxes is not in accordance with previous Commission orders. Staff points out that nothing in the AFOR agreement, or in any of the Commission orders dispersing excess profits, indicates any intent by either the Commission or the Company to offset the adjustments to accumulated depreciation with an adjustment to the accumulated deferred tax balance.

Public Counsel/TRACER witness Carver proposes Adjustment B-4 to accomplish the same functions as the Commission Staff proposal. Public Counsel/TRACER agree that one of the adjustments is needed in order to preserve the ratepayer benefits of the Sharing proceedings. They point out that no Commission order "directed" a deferred tax adjustment associated with the Sharing proceedings, and argue that therefore there is no violation of the Tax Code. They urge, if the Commission rejects the proposed adjustments, that it establish a regulatory liability account not requiring normalization, or that it revisit the Sharing proceedings and consider direct refunds in lieu of depreciation credits.